Emerald Advisers, Inc.
Diversified Small Cap Growth

Q2 2014 | Economic & Portfolio Commentary

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Small Cap Absorbs Market Correction

By all accounts it was a tough quarter for small capitalization stocks. While the absolute returns for the quarter were positive with the Russell 2000 Growth gaining 1.72%, the month to month movements were much more abrupt than evidenced by the final result. Performance was truly a tale of two halves.

Market Update

The first half reflected the continuation of concerns that surfaced in March over the trajectory and timing of interest rate increases, declining treasury yields and both economic and earnings reports that were disappointing relative to consensus. With these concerns at the forefront, the fastest growing stocks across the capitalization spectrum came under pressure as investors re-evaluated current valuations. As a matter of fact, from March 7th through May 16th the Russell 2000 Growth index declined 11.11%, reaching official correction territory. This valuation correction was swift and abrupt and confined predominantly to small capitalization stocks, as the S&P 500 over the same period, increased by 0.45%. The selling pressure began to abate in Mid-May, coincident with a broad improvement in macro-economic statistics. With first quarter GDP weakness increasingly looking like an aberration, concerns eased regarding the economic outlook, and the Russell 2000 Growth rallied 9.68% from May 16, 2014 through June 30, 2014.

Portfolio Review

Although the Russell 2000 Growth was able to recover from its mid-quarter trough, the fastest growing companies in the index, those that had led in the first quarter, lagged in the second quarter. Therefore, while relative performance for the Emerald portfolio improved during the second half of the second quarter in

Key Points:

- Performance within small capitalization and most notably small capitalization growth stocks trailed their value and larger capitalization counterparts during the quarter as concerns over the trajectory and timing of interest rates increases, declining treasury yields and concerns over the forward rates of earnings and economic growth pressure valuations.

- Although the Russell 2000 Growth staged a nice recovery from the middle of May through the end of June, in conjunction with the improvement in the outlook for economic growth, the companies with the highest earnings growth rates lagged for the quarter.

- The portfolio underperformed the Russell 2000 Growth index for the quarter as broad underperformance of the fastest growing stocks and a number of company specific earnings disappointments proved insurmountable from a performance perspective. From the standpoint of attribution, stock selection within the technology, financial services and healthcare sectors weighed on relative performance.

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in concert with improving sentiment toward growth stocks, portfolio performance lagged on a full quarter basis. Broad underperformance of the fastest growing stocks and a number of company specific earnings disappointments proved insurmountable from a performance perspective. More specifically, from an attribution standpoint, stock selection within the technology, financial services and healthcare sectors weighed on relative performance.

Of the aforementioned hindrances to performance, the technology sector was the largest detractor to return for the period. Stock selection within the software, communications and semiconductor industries proved most challenging as a result of the broader valuation correction and several company specific earnings disappointments.

consumer discretionary sectors. Within financial services, the banking industry remains a key area of focus. Although, the second quarter proved more challenging than anticipated, given declining treasury yields, Emerald continues to anticipate that small capitalization banks, and our holdings in particular, will post solid earnings reports driven by strong commercial loan growth, reduced non-interest expense and stable net interest margins. Non-residential construction/investment indicators continue to inflect positively and should remain a tailwind to loan growth as we move through 2014. The portfolio is also participating in the improvement in non-residential construction through its exposures in the producer durable and materials sectors with investments in the equipment rental, electrical distribution, construction, building materials and glass industries.

> Emerald continues to believe that earnings across all capitalizations are poised to accelerate in 2014, in conjunction with accelerating growth in global developed markets. Further, we believe that the cycle of innovation that has fueled earnings over the last 3 years continues unabated.

After a challenging second quarter for the technology sector, Emerald has moved to an underweight position in the portfolio. While we continue to believe there are significant investment opportunities longer-term as companies continue to solve problems and enhance productivity of the enterprise through innovation, we have become less enthusiastic near-term regarding the breadth of the opportunity set. It is our observation that the heightened focus and spending on security initiatives appear to be both consuming an increasing percentage of the overall information technology budget and simultaneously delaying spending in other areas, particularly networking, limiting the investment opportunities within the sector.

Entering the third quarter, the portfolio had the largest active exposure to the producer durable, financial services and

Market & Portfolio Outlook

As we enter the second half of 2014, the domestic economy appears to be regaining its footing after contracting in the first quarter of this year. Sources of strength are increasingly broad-based with ongoing strength in auto sales, rising consumer confidence, consistent employment growth, re-accelerating housing statistics, continued expansion in manufacturing and commercial lending as well as a bevy of data that point to an increasingly encouraging outlook for non-residential construction. Bond yields have similarly risen from their recent trough and stand around 2.57%. Historically, rising 10-yr. US Treasury yields have been positively correlated to equity market performance and we see no reason why that will not be true this time as well.

Valuation, which is often discussed as a headwind to future market appreciation, does not appear to be hindering deal activity. In fact it seems to be a driving factor behind the acceleration in activity experienced year-to-date, as companies are increasingly using their stock as the currency of choice. In that regard, the cash consideration portion of the total deal value has declined to 60%, falling below the 73-76% level where it has ranged over the last four years, according to a recent report from Goldman Sachs. Collectively, the appreciation in equity prices over the last three years, a stable to improving outlook for economic growth and increasing confidence in the corporate suite, have united to drive a significant acceleration in merger and acquisition activity. The value of global merger and acquisition (M&A) activity grew to $1.75 trillion in first half of 2014, according to the Financial Times, an increase of 75% year over year, and the highest level since 2007. Domestically, according to a recent report from Goldman Sachs, announcements during the first half of 2014 have increased by roughly 50% year over year to $744 billion. From a fundamental perspective, the acceleration in deal flow is encouraging, with the average premium tracking close to 26% year-to-date.

While merger and acquisition activity lends support to current valuations, in our opinion, it is ultimately earnings growth that will be the primary driver of further market appreciation. In that regard, building economic strength should translate into accelerating earnings growth as the year progresses and we believe small capitalization stocks remain well positioned to reap the gains of faster developed market growth. Further, we believe that the innovation cycle that has fueled earnings growth over the last three years remains ongoing and broad-based, with opportunities spanning biotechnology, medical devices, energy exploration and production, software (cloud delivery) and security applications, financial services, and industrials. Small capitalization stocks, in our opinion, have, and continue to be, at the epicenter of this innovation cycle.

In the near-term, however, we believe that day to day market movements are likely to remain choppy. While there has been much discussion related to the broad complacency of market participants given the persistently low level of the CBOE Volatility Index (a measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices), the volatility amongst small caps has actually accelerated year-to-date. According to a recent report from Steve DeSanctis at Bank of America Merrill Lynch, the percentage of days in which the difference between the high and low has exceeded 2% has accelerated from 5% in 2012 and 2013 to 13% in 2014. Anemic trading volumes are likely partially to blame for the heightened volatility. June trading volume fell to 5.8 billion shares per day, which was the lowest volume for any June since 2006, and was down 18% year over year. While the lack of volume certainly adds to the ease at which prices vacillate, both the heightened small cap volatility and low volumes seem to be more indicative of the fragility of current market sentiment and the broad uncertainty about the near-term direction of the market.

In that regard, with each passing day that the melt-up in the S&P continues, the drumbeat for a broad market correction grows a little bit louder. According to Goldman Sachs, the S&P, through early July, has been above its 200 day moving average for more than 400 days. This phenomenon has only occurred four other times in history, and the average duration on those occasions was 524 days with the most recent stretch from 1954-1957. Adding to the more fragile sentiment are accelerating geopolitical tensions and the increasing probability for a more contentious domestic political climate as the mid-term elections approach in November. While the risk of a correction remains real, Emerald believes that any broader market correction would most likely be driven by technical market factors versus any abrupt change to the economic outlook.

As always, Emerald remains focused on utilizing its fundamental bottom-up research process to identify the best growth opportunities within the small capitalization universe. Exiting the second quarter, the portfolio remains positioned in the best growth opportunities which are reflected at the sector level in overweight positions in the producer durables, financial services, and consumer discretionary sectors, with the technology and the consumer staples sectors being the most underweighted.

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Emerald is an asset management firm providing research-based portfolio management. We provide growth-oriented and income-producing portfolios for institutions and individuals.

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